Divergent Real Economies in Europe

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OUTLINE

In this paper, the well-known convergence programs, implemented by the EU member-states, are closely evaluated. Using descriptive statistical analysis and the changes in the real exchange rates as analytical cornerstone, the paper focuses on the economic performance of the member-states since the accord (Dec. 1991) and the ratification (Febr. 1992) of the Maastricht Treaty. Changes in the trade balance, industrial production, rates of unemployment, inflation and interest rates (short-term and long-term) are used as criteria of success both in real and nominal terms. The statistical outcomes are compared with the ones found in similar research done by R. Gordon. The paper ends with the evaluation of the results and the policy lessons which can be drawn by the different exchange rate policies followed by the member-states.

1. Introduction

There has been much discussion in the literature on the issue of the European Economic and Monetary Unification. On the one side, there are authors who clearly emphasize the benefits stemming from the establishment of the common currency, paying attention mainly to the abolishment of transaction costs, the increase in trade and macroeconomic stability (European Economy 1990, Emerson et al. 1992, Gros and Thygesen 1992). The replacement of national notes and coins by the EURO at the threshold of the new century is said to benefit national economies by reducing uncertainty on interest and exchange rates, providing a better exchange for tourists and industry, diminishing red tape and bureaucracy created by banks, and establishing a strong and stable currency - guaranteed by the European Central Bank - which will allow better access to markets within and outside the EU for European enterprizes. It is believed by "pro-European" economists, politicians and policy-makers that in this way Europe will succeed, in the coming years, with high growth rates so as to reduce unemployment, poverty and social marginalisation around Europe.

On the other hand, sceptisism about the benefits of establishing the EURO as well as the way of constructing the new Europe in general, is mainly based on the theory of Optimum Currency Area (OCA) (Mundell 1961, McKinnon 1963, Kenen 1969). The Maastricht Treaty is considered to be -at least- imperfect, if not mediocre, from many aspects. The mobility of the factors of production across Europe, namely labor and capital, have not increased and remain at low levels (Bayoumi and Eichengreen 1992, Feldstein 1992, Pelagidis 1996a, 1996b). The European budget and in particular, the funds going to disadvantaged regions and poor countries are still less than the aid needed in order for economic activity and employment to be restored (Bayoumi and Eichengreen 1994, Sala-i-Martin and Sachs 1991). In conclusion, it is argued that Europe does not fullfil the basic conditions to be an optimum currency area and the costs of establishing a common currency, namely output loss and high unemployment, are said to be too high to offset the benefits.

There are also authors who argue in favor of the establishment of the EURO, disagreeing with the way the EMU has been pursued up to now (De Grauwe 1995, 1996a, 1996b). Convergence criteria set by the Maastricht Treaty are considered to be responsible for high unemployment and economic stagnation around Europe which, in turn, have spread pessimism and disenchantment with the EMU among European citizens.

The purpose of this paper is not to argue for or against EMU, although in a previous paper (Pelagidis 1996a) we have clearly argued that the criteria of the OCA theory are not met in the European case and the prospects are not favorable. Specifically, attempts to meet the convergence criteria have worsened member-state's economic performance and the move towards monetary unification risks ending in failure.

This paper examines the economic results of the policies applied in the fifteen European countries, since the period 1991/92. The well-known convergence programmes implemented by national economies are closely evaluated. Using descriptive statistical analysis and the changes in the real

exchange rates as analytical cornerstone, the paper focuses on the economic performance of the member-states since the accord (Dec. 1991) and the ratification (Febr. 1992) of the Maastricht Treaty. Changes in trade balance, industrial production, rates of unemployment and interest rates (short-term and long-term) are used as criteria of success both in real and nominal terms. The statistical outcomes are compared with the ones found in similar research done by R. Gordon (1996).

The paper ends with the evaluation of the results and the policy lessons which can be drawn by the -different exchange rate- policies followed by the EU member-states.

2. Real convergence in Europe: What the evidence tells us

Although deflationary policies in general have been implemented throughout member-states since the early '90s, some countries appear to have followed different paths to meet the convergence criteria set by the Treaty of Maastricht. This policy differentiation refers mainly to the exchange rate policy and concerns European countries both outside and within EMS.

After five years implementing policy prescriptions, evaluation in professional journals as well as assessment by EU official authorities refer mainly to *nominal convergence*. The real economy, that is, output and employment, although of cardinal importance as a means of combating poverty and preserving social cohesion, were kept out of the evaluation. The persistant emphasis on the so-called nominal criteria and especially the concentration on policy tools for fighting inflation, has brought the highest levels of unemployment in Europe since the Depression, exacerbated social tensions and as a result, the achievement of further integration has been seriously threatened.

However, not all EU member-states have done so badly, even on the real economy front. Those which kept their currencies "hard" and their interest rates relatively high in the EMS context came out with high costs in terms of loss of industrial production, adverse trade balance and unemployment. This is not a surprise. Abandoning the exchange rate tool, while implementing at the same time contractionary fiscal and monetary policies in line with the Maastricht convergence criteria, the only way left to stabilize the economy is by deflationary policy. In other words, deflation took the place of currency devaluation, forcing the burden of adjustment mainly into the labor market (Dornbusch 1996). In the case of Europe, the burden of adjustment, under the previously circumstances falls mainly to poor regions/countries and to labor in particular.

Standard macroeconomics indicate that if exchange rates are pegged too tightly, internal and external imbalances are likely to emerge and can do far more damage to the countries involved in the -European monetary- system (Kenen 1994). Taking as a criterion the exchange rate policy followed by the member-states, we will examine bellow the performance of member-state's real economies, looking at the same time at the progress on real convergence after five years of implementing expenditure-reducing economic policies in the EU. Using descriptive statistical analysis, we will evaluate the cost of adjustment for each country separately.

Economic performance according to industrial production and trade balances, interest rates (long-term and short-term) and unemployment will indicate wether we are going to have converging standards of living in Europe or, on the contrary, a "multi-speed Europe", which will establish different levels of prosperity within the EU.

2.1 Exchange rates (Table 1)

The year 1992, marks a change in exchange rate policy of most of the member-states after the collapse of the ERM. Some of them left EMS and some others, while staying within the EMS, followed a much more flexible exchange rate policy. In Table 1 we observe that the cumulative (1991-95) real effective exchange rate change in Italy (-35.6), Sweden (-25.6), Finland (-21.8), Spain (-18.5), Ireland (-15.6) and G. Britain (-12.8) was negative, which means that the currencies of the above countries depreciated (IMF World Economic Outlook 1996, p.140). Austria kept its currency almost stable vis-a-vis the other European currencies, although according to other sources (Eurostat & DGII 1996, p.61), real overvaluation of its currency reached 13%-14%. The Portugese Escudo was also kept almost constant, while its slight cumulative overvaluation (+6.8) took place only in the year 1992, just before the collapse of the ERM. Finally the Belgian currency also remained constant.

On the contrary, the "hard" currency group includes mainly the countries of the European North. Real cumulatively (1991-95) revaluation is marked in Germany (+21%), Denmark (+8.9%), the Netherlands (+5.6%) and France (+4.9%), while with surprise we observe that Greece is included to this group of countries. Its currency was overvalued cumulatively (1991-95) +12.2%. High real overvaluation of a "weak" currency presupposes high interest rates in order for the currency to be efficiently supported. Official reserves in Greece reach about 20 bil. $ and, as we will see below, the greek interest rates are the highest in Europe.

Finally, in the case that a currency is highly overvaluated, according to standard macroeconomics, we should expect -to an extent- negative impacts on the trade balance and on the growth rate of industrial production.

Table 1
*Real effective exchange rate**
(Annual percentage change; 1991-1995)

	1992	1993	1994	1995	1991-1995**
D	3.3	7.9	2.3	7.5	21.0
F	0.8	2.1	-	2.0	4.9
UK	-	-6.5	0.8	-4.1	-9.8
I	-1.8	-17.5	-5.3	-11.0	-35.6
E	0.8	-9.7	-8.0	-1.6	-18.5
NL	2.7	2.8	-1.6	1.7	5.6
B	1.0	-0.9	-0.4	1.8	1.5
SW	1.0	-23.6	-1.7	-1.3	-25.6
A	0.6	-0.2	-2.1	0.2	-1.5
DK	1.8	3.1	-0.3	4.3	8.9
FIN	-18.3	-16.0	3.3	9.2	-21.8
IRL	-2.0	-7.8	-4.2	-1.6	-15.6
GR***	-2.5	2.6	5.6	6.5	12.2
P***	6.0	-0.9	-0.1	1.8	6.8

Source: IMF World Economic Outlook (1996), p.140
*Doubled export weights; % change p.a.; on the basis of unit labor costs in the total economy
**Cumulative percentage
*** Eurostat & DGII (1996), p.61

2.2 Interest Rates (Table 2)

Looking at Table 2 and taking as an "anchor" the German interest rate, we observe that the Netherlands, Belgium, Denmark, Austria, Finland and France sustain a group of countries with interest rate differentiation less than 1% from the German rate. All the above countries, with the possible exemption of Finland, belong to the so-called "hard currency" group.

On the contrary, Sweden (2.4), Ireland (5.3), Spain (4.0), Portugal (4.0), Italy (5.3) and G. Britain (5.3), that is the so-called "soft currency" countries, seem to keep their interest rates much higher than the "hard currency club", in order to manage -with the exemption of G. Britain- to keep their currencies within the ERM bands. The interest rate differentiation of Greece is around 10%, in order to efficiently support the artificially "hard" national currency.

According to the empirical evidence above, despite the fact that the "soft currency" countries followed a much more flexible exchange rate policy since 1991, nominal interest rates continue to be 2.4-5.3 percentage points higher than the German ones. This appears to be a precondition for the "soft currency" countries to preserve their currencies within the bands of the ERM.

The same outcomes can be also observed in Table 2 as far as it concerns the nominal long-term interest rates.

Table 2
Interest rates (July 1996)

	Nominal short-term	DGR*	Nominal long-term	DGR*
D	3.3	-	5.9	-
F	3.8	0.5	6.3	0.4
UK	8.6	5.3	8.3	2.4
I	8.6	5.3	8.8	2.9
E	7.3	4.0	8.1	2.2
NL	3.0	-0.3	6.7	0.8
B	3.3	0.0	6.8	0.9
SW	5.7	2.4	8.3	2.4
A	3.5	0.2	6.5	0.6
DK	3.8	0.5	7.2	1.3
FIN	3.6	0.3	6.2	0.3
IRL	8.6	5.3	7.7	1.8
GR	14.0	10.7	14.8 (May)	8.9
P	7.3	4.0	7.2	1.3

* Difference from the German Rate (DGR)
Source: Eurostat & DGII (1996)

2.3 Industrial production (Table 3)

In Table 3 we can see that the member-states with appreciated national currencies; that is Germany, France, the Netherlands, Belgium, Portugal and Greece, experienced both cumulatively, and on average, very low growth rates of industrial production. In particular, Germany's average index is negative (-0.34) while the corresponding numbers for the rest of the "hard currency" countries are below 1%, with the exemption of the Netherlands at around 1%.

On the other hand, those member-states which followed a much more flexible exchange rate policy and left their currencies to fluctuate more freely than the others, such as Sweden, Finland, Italy and G.Britain -all outside the EMS- have an average growth rate of industrial production which ranges between +2.5% and +6.2%. Ireland, with its currency depreciating at around 20% since 1991, did extremely well. Ireland's cumulatively industrial growth rate during the period 1992-96 was 56.4%, a yearly average of 11.2%.

Table 3
Industrial production
(1992-1996 cumulative percentage)

	1992-96	1992-96 Average (yearly)
D	-1.7	-0.34
F	1.4	0.28
UK	12.0	2.40
I	12.4	2.48
E	4.6	1.15
NL	5.3	1.06
B	2.1	0.42
SW	21.6	4.32
A	7.8	1.56
DK	16.8	3.36
FIN	30.9	6.18
IRL	56.4	11.28
GR	1.6	0.32
P	2.0	0.40

Source: OECD (1996), p.A14 and own calculations

2.4 Trade balance (Table 4)

In the two columns of Table 4, we see once again that most of the countries which implemented a flexible exchange rate policy either by staying outside EMS -or inside but taking advantage of the wide band of +/-15- improved their competitive position in the markets. Together with the better performance of these member-states as far as industrial production is concerned, trade balance also improved. Italy reversed its trade deficit to a trade surplus of 2.8% as a % of GDP; Sweden and Finland doubled their trade surplus, while Ireland saw its surplus to increase from 11.7% to 18.1% (as a % of GDP).

Spain, G. Britain and Austria decreased their trade deficit, while, on the contrary Greece's deteriorating trade deficit fits very well with the highly overvalued national currency which worsens the poor industrial base of the country by undermining its international competitiveness.

Table 4

Trade balance as a % of GDP

	1992	1996
D	1.4	3.1
F	-0.3	0.6
UK	-2.8	-1.6
I	-0.8	2.8
E	-5.9	-4.2
NL	2.3	3.9
B	-2.1	-1.0
SW	2.3	6.0
A	-5.0	-3.0
DK	4.6	3.2
FIN	2.6	6.7
IRL	11.7	18.1
GR	-13.9	-14.9
P	-13.2	-9.9

Source: Eurostat & DGII (1996)

2.5 Unemployment (Table 5)

As far as unemployment is concerned, G. Britain (-1.7) and Ireland (-4.0) depreciated their currencies and reduced their rates of unemployment despite Europe's economic stagnation. On the contrary, member-states in continental Europe, with the exemption of Denmark (-2.8%), saw their unemployment rate deteriorate. Expenditure-reducing policies along with "hard currency policies" increased the unemployment rate, worsening the prospects for further economic and monetary unification in Europe.

Table 5

Extra Unemployment (1996 minus 1992)

D	2.6
F	1.3
UK	-1.7
I	2.9
E	4.0
NL	1.6
B	2.8
SW	3.0
A	0.7
DK	-2.8
FIN	3.2
IRL	-4.0
GR	1.2
P	3.3

Source: Eurostat & DGII (1996)

According to the above evidence, it is suggested that the member-states with flexible exchange rate policy, either inside or outside the EMS, witnessed the best results as far as the "real economy" is concerned. This implies that a better policy prescription for the rest of the member-states could have improved economic performance around Europe, reducing poverty and increasing employment and output. In other words, convergence criteria appear to have caused divergence in the real economies, causing higher rates of unemployment and economic stagnation and spreading, at the same time, social unrest and discontent within the E.U.

However, enthousiastic supporters of the EMU, point out that deflation is the only way to bring down inflation and create the appropriate conditions for growth. According to the -well known- "credibility" economic doctrine (Persson and Tabellini 1996), fixed exchange rates and expenditure-reducing policies are needed for the road to EURO in order for member-states to take advantage of "credibility" in the markets, to attract foreign capital and spur growth.

Despite the teachings of the "credibility" school, low inflation in Europe has neither caused higher growth rates nor increased employment. However, most national governments and Central Banks keep implementing deflationary policies all around Europe. At the Dublin Intergovernmental conference indeed, additional decisions were taken to restrict further budget deficits and to punish the member-states of the EURO zone which do not obey the rules. Taking into account that exchange rates will be irrevocably locked after 1/1/1999, the burden of adjustment is expect to fall exclusively to the labor market (Dornbusch 1996, Kapstein 1996), which means further loss of output, even higher rates of unemployment and low GDP growth.

In this context, it is of upmost importance to examine the effectiveness of the deflationary policies implied in the EU member-states, looking at their results as far as the sacrifice ratio and the deceleration of inflation is concerned.

3. "Sacrifice ratio"

The cost of economic policies implied under the Maastricht convergence programmes to the EU member-states, can also be evaluated by using the "sacrifice ratio", that is by using the ratio of cumulative unemployment above the 1990 level divided by the disinflation between 1990-96, using the consumer price inflation index.

According to the data concerning inflation and unemployment rates, we estimate the sacrifice ratio for Europe as a whole to be 1.45 for 1990-96, while during this period, unemployment increased 3.2% and inflation went down by only 2.2% (Eurostat & DGII 1996).

On the contrary, as seen in the Table 6, the sacrifice ratio for the same period is much lower in non-EU countries such as the USA, Canada, Norway etc. It can also be observed in the following table that EU member-states such as Italy and G. Britain which left the EMS in 1992 have done better than the countries participating in the ERM of the EMS.

Table 6

*Sacrifice ratio (cumulative average)**

	1990-1996	1992-1996
Non EMS members		
USA	-0.03	-10.00
Canada	0.42	-4.00
Australia	0.47	0.83
Norway	-0.47	-16.00
G. Britain	0.30	-2.00
Italy	1.50	2.70
N. Zealand	-0.33	-13.66
EMS members		
Germany		0.81
France		2.16
Spain		1.42
Netherlands		1.33
Belgium		28.00
Sweden		15.00
Austria		0.38
Denmark		-14.00
Finland		1.33
Ireland		-20.00

* The sign plus (+) means a positive sacrifice ratio. The highest the ratio the highest the cost - in terms of unemployment- of bringing down inflation. On the contrary, the sign minus (-) means that deflation was followed by a deceleration of the unemployment rate.
Source: OECD (1996); Own calculations
For the year 1996: European Economy (1996) and IMF World Economic Outlook (1996); Own calculations

Looking closely at the outcomes of the sacrifice ratio calculations, we see that all countries participating in the EMS brought down inflation with higher cost in terms of unemployment and in terms of production output than most of the OECD countries. Participation in the EMS appears not to be an advantage for reducing inflation in the '90s, a fact that already has been mentioned by Dornbusch (1989) and Collins (1988) for the decade of the '80s (1981-1988). Collins examining the period 1979-1986 and, concentrating on France, shows that the regulations as well as the narrow bands that EMS imposed on the French franc had no favorable effects on the long-term exchange rate stability of the national currency as well as on inflation. Dornbusch (1989) argues that if it is true that the ERM provides its members with "credibility", then we would expect a lower sacrifice ratio for these countries in the '80s, that is, lower inflation with a lower comparatively increase in unemployment. This neither happened in the '80s, nor, as proved by empirical evidence presented in this paper, in the '90s. On the contrary, countries remaining outside the EMS brought down inflation either without any unemployment increase or with relatively lower sacrifice ratio than the EMS "insiders".

There is another important implication of the analysis above. Despite the fact that countries outside EMS, especially after its collapse in 1992, “unlocked” their currencies from the EMS narrow bands and depreciated their currency, this policy did not lead to an inflationary resurgence. On the contrary, the slow down of the growth of the inflation rate was even faster for the "EMS outsiders" than the reduction of inflation for the "EMS insiders". Sweden, Finland, Italy and G. Britain, while they remained outside the EMS during 1992-1996, secured a faster deceleration of inflation than the average EU inflation deceleration.

In conclusion the evidence presented does not credit those authors arguing that any currency depreciation leads to higher inflation. In Friedman's (1953) words, "...a fear of inflation has little or no chance of producing inflation, except in a favorable monetary environment". "Credibility" given by the EMS does not appear to help "insiders" to either achieve lower sacrifice ratio or even to reduce inflation rates, faster than the "outsiders". Thus, better economic performance seems to depend on implementing the appropriate policy-mix and not, as the "credibility" paradigm implies, on the establishment of independent authorities -such as the Central Banks- of rigid policy "rules" based on "inflation targeting" and on narrow exchange rate bands. An economic policy mix is considered successful and "credible" when it restores internal and external balance, that is, when it brings down inflation, preserves full employment and keeps an equilibrium in external balance. A "credible" economic policy does not mean fighting inflation at any cost.

On the same principle, Gordon (1996) argues that those member-states which withdrew their currency from the EMS after 1992 (Italy and G. Britain), or others, while remaining insiders, who depreciated their currencies (Spain, Portugal, Sweden), experienced a reduction in inflation rate which was 0.4% faster than the inflationary reduction in countries that implemented strict deflationary policies. In addition, they witnessed a nominal growth rate 1.3% (1.7% in real terms) higher than countries which saw their currencies appreciate. It should be mentioned that in his research, Gordon (1996) includes in "appreciating countries" only Austria, Belgium, France, the Netherlands and Switzerland and estimates their currency appreciation in nominal terms.

Table 7

Change in Effective Exchange Rates and Growth Rates of Nominal GDP and GDP deflator, 1992-95. Five appreciating and five depreciating countries

	Appreciating*	Depreciating**	DDA***
Effective Nominal Exchange Rate (1995-1992)	10.2	-22.2	-32.2
% change in Nominal GDP (1995-92)	0.4	1.7	1.3
% change in Real GDP 1995-92	1.0	2.7	1.7
% change in GDP Deflator 1995-92	-0.6	-1.0	-0.4

*Appreciating countries: Austria, Belgium, France, Netherlands, Switzerland
**Depreciating countries: Italy, Portugal, Spain, Sweden and the United Kingdom.
***Difference Depreciating minus Appreciating
Source: Gordon (1996), table 2

Similarly, Helpman, Leiderman and Bufman (1994), examining exchange rate policies and inflation in Chile, Israel and Mexico, have observed that in Chile, where the national currency depreciated, inflation was brought down, and indeed that the possibility of expected devaluation was very low. On the contrary, in Israel and Mexico, due to currency appreciation, the possibility of a sudden devaluation proved to be much more likely.

Besides better performance in inflation rates and GDP, the outside EMS countries appeared to have done better in both reducing budget deficits and, more importantly, in reducing the actual (a) minus structural (s) deficit, as can be seen in the Table 8 below.

Table 8

Comparison of actual (a) and structural (s) budget deficit/surplus as a % of GDP*

		1993	1996
Italy	(a)	-9.6	-7.8
	(s)	-8.7	-7.5
	(a-s)	-0.9	-0.3
G. Brit.	(a)	-7.7	-3.2
	(s)	-5.0	-2.0
	(a-s)	-2.7	-1.2
Finland	(a)	-7.1	-3.3
	(s)	-3.4	-2.6
	(a-s)	-3.7	-0.7
Ireland	(a)	-2.4	-2.0
	(s)	-2.3	-2.5
	(a-s)	-0.1	+0.5
Spain	(a)	-7.5	-5.2
	(s)	-5.5	-3.5
	(a-s)	-2.0	-1.7
Sweden	(a)	-13.5	-9.7
	(s)	-9.9	-8.4
	(a-s)	-3.6	-1.3

Source: Giorno et al. (1995) and own calculations
*The structural deficit/surplus is estimated as a % of potential output

The accomodating monetary policy, together with currency depreciation policy, which the countries of the above table implemented, reduced the part of the budget deficit created by the economic stagnation. If this policy would have been applied all over the EU, combined also with proper structural policies, the "natural rate" of unemployment, that is, the rate that would be determined by the private sector in the absence of monetary disturbances, could have been much lower in Europe. In G. Britain and in Ireland between 1992-1996 we had a reduction in unemployment of -1.7% and -4.0% correspondingly. The fact that, as seen, the inflation rate in these countries had also been reduced, proves that there is enough margin for further reduction of the rate of unemployment without the danger of inflation.

Thus, a new policy mix based on some coordinated monetary expansion (Modigliani 1996) and exchange rate flexibility in Europe appears that it could pull down both the actual and natural rates of unemployment, increase rates of growth and reduce budget deficits without politically difficult budget-cutting. Demand expansion, by creating jobs may also reduce the transition costs of policy reform which create temporary unemployment.

4. Conclusions

In this paper, we have examined aspects of real economic divergence among EU member-states. Deflationary policies across Europe spread by the implementation of convergence programmes in most of the member-states appear to have created serious problems in real economic performance. Exchange rate fixity in the context of the ERM seemed to be the main factor which determined interest rates and as a result, industrial production, trade performance and unemployment.

Through descriptive statistics, we observed that there is a trade-off between exchange rate fixity and economic performance in the real economy. Countries which depreciated their currencies, either inside or outside the EMS, did better in the growth rate of industrial production, increased trade surplus or reduced deficit and decreased unemployment. On the contrary, countries that appreciated their currencies, having either a "hard currency" (eg. Germany) or a "weak currency" (eg. Greece), witnessed a deterioration of the above performance criteria.

Suprisingly, according to the evidence presented, depreciating countries also did better in decelarating inflation. This is not actually a heretical view. Collins (1988), Dornbusch (1989), Helpman, Leiderman and Bufman (1994), have also argued that inflation has, in many cases in the past, decelerated along with coincidental currency depreciation.

The "sacrifice ratio" was also lower for depreciating countries. Inflation was brought down with less cost in terms of unemployment than in the appreciating countries. Also, Gordon's research has shown that depreciating countries in Europe have increased GDP more than the countries which implemented a "hard currency" policy.

Finally, depreciating countries seemed to have done better in both reducing budget deficits and, more important, reducing the difference “actual-structural deficit.

It is not the purpose of this paper to propose a new policy agenda. However, in the present conditions of 18.5 million unemployed Europeans and 50 million in poverty, it is certain that Europe needs a change in the policy mix implemented up to now. The ERM as applied, has proved to be a regime of permanent deflation and mass unemployment. The effort of countries with "weak currencies" to cut budget deficits, keeping at the same time their exchange rate artificially high, has been pursued through reducing demand, that is, by applying expenditure-reducing policies and by keeping interest rates at high levels in order to attract foreign capital and finance external deficits. With all member-states trying to become more competitive by cutting demand, increasing taxes and reducing public expenditures (competitive disinflation), the net result is economic stagnation and high unemployment (Toporowski 1995). As a consequense, further -European- unification, member-state's cooperation and social peace are seriously threatened. Why not then start with a coordinated stimulus program right now, before Europe falls victim to "economic orthodoxy" beloved of central bankers (Soros 1996)?

This programme should include the implementation of expenditure-switching policies across Europe focusing on public investments and the possibility of national governments, confronting internal and external instabilities, to use the highly important - as proved by this paper- exchange rate policy instrument in order to stabilize their economy. In this way,

employment will increase, poverty will be reduced and social cohesion will be strengthened. Otherwise, if Brussels leaves economic policy to “central bankers”, the pursuing of common currency through austerity and mass unemployment will continue, facing the risk of the EURO project ending in failure. The common currency is originally a good idea but only in a regime of full employment and prosperity.

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